Government Technology and Business Services, Inc.

White Paper

Benefits of Implementing a Framework for Internal Controls

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Introduction

Volumes of information are available that define internal controls and numerous regulations, standards, and laws specify internal control requirements. Organizations produce pages of policies, standards, and procedures to try to communicate and document internal controls in place. Despite all of this information, implementing internal controls can be ineffective or inadequate without a framework that leads managers from theoretical ideas to practical actions.

A Framework for Internal Controls Treats Controls as Part of a Business Process

A Framework for Internal Controls treats internal controls as a system of actions that are embedded within businesses processes. Treating internal controls as a part of business process naturally focuses managers on the business activities instead of the internal control theories. Instead of analyzing a business process for internal controls, a business process is analyzed as:

- A set of defined business objectives
- Risks associated with the business objectives
- A series of transactions and decision points that support business objectives

These components are the foundation of a Framework for Internal Controls and allow managers to focus internal controls on the most critical, highest risk, most voluminous business processes. Using a Framework for Internal Controls allows managers to develop actions that support the business objectives by applying controls at the most critical points in a process. As a result, internal controls are incorporated as systematic actions that support the business objectives.

Using a Framework of Internal Controls also provides a structure managers can use to organize supporting documentation. When managers or auditors evaluate business systems for internal controls, the supporting documentation such as policies, procedures, and forms can be retained in knowledge management tools using the same framework to clearly identify how the business objectives are controlled and documented.

A Framework for Internal Controls Ties Controls to Business Objectives

Internal controls are more likely to guard against inefficiencies, inaccuracies, and non-compliance with regulations than expose fraud. However, employees often associate the concept of internal controls with an environment of mistrust, invasive oversight, and more work. By linking internal controls to business objectives instead of the risks they are introduced to address, managers can create an environment in which internal controls are accepted as part of the business processes and objectives.

A Framework of Internal Controls Assess Effectiveness of Business Processes

A Framework for Internal Controls measures the effectiveness of internal controls based on business results achieved. Business objectives provide a measurable basis against which to assess the effectiveness of internal controls by assessing if business objectives are met. Internal controls are measured with the same valuations used for the business objectives. For example, if the business objective is a dollar value, internal controls are assessed by measuring the dollar volume of errors detected and corrected, losses prevented, or assets safeguarded. If business objective is a quality metric such as a percentage, internal controls are assessed based on the percentage of defective products or services.

Emphasizing the potential business impact of inadequate or ineffective internal controls creates an environment where internal controls are valued for the contributions they make to the business objectives including:

- Increasing effectiveness and efficiency of operations
- Improving reliability of financial reporting
- Ensuring compliance with laws and regulations

A Framework for Internal Controls Balances Controls with Risk

No system of internal controls can efficiently prevent all errors and irregularities. Risk is the probability that an event or action will adversely affect the organization. The primary categories of risk are errors, omissions, delay and fraud. In order to achieve goals and objectives, management needs to effectively balance risks and controls. Therefore, control activities need to be developed so that they decrease risk to a level where management can accept the exposure to a risk. By performing this balancing act reasonable assurance can be attained. Excessively controlled business processes can create problems including:

- Increased bureaucracy and inefficient operations
- Reduced productivity
- Overly conservative business decisions
- Increased complexity
- Increased processing time for transactions

A Framework of Internal Controls provides a risk-based range of internal control activities that allows managers to select the most efficient and effective control activity for a transaction or decision point. By using business objectives as the framework foundation, managers assess and document risk from a business perspective. Managers understand risk as the factors that can jeopardize achievement of the business objectives. Using a Framework of Internal Controls to assess risk requires that:

- The organization and each department within the organization document goals and objectives
- Risk is assessed at the business process level within each department
- A standard risk assessment is applied throughout the organization so that risks can be prioritized and ranked

A Framework for Internal Controls Evolve as Business Processes Evolve

Business objectives and business processes evolve over a period of years or decades and are often molded around changes in business conditions, technology, or regulatory mandates. Frequently, business processes undergo significant changes within a defined timeframe that does not permit sufficient time or resources to evaluate multiple options for efficiency and effectiveness. Internal controls in these types of business processes also need to evolve and often without the time and resources managers need to select specific controls and strategically insert them to achieve the most benefits.

A Framework of Internal Controls captures:

- The historical reasoning and logical thought that managers use
- To select
- The most appropriate internal controls at the most effective points in the business process. By

Retaining the information and criteria used to analyze a business process for internal controls creates the blueprint needed when business processes change and internal controls also need to change; or at least be evaluated for change.

A Framework for Internal Controls Simplifies Understanding and Communicating Internal Control Activities

The body of internal controls is basically standardized and several regulatory agencies and professional institutes provide a list of possible controls for business processes and automated information systems. Each organization or department develops a listing of control activities as the first step in building a Framework of Internal Controls. The standardized listing of control activities is distributed to managers and they select the control activities appropriate for each business process based on the risk associated with the process. The following table lists standard control activities and assigns a unique identifier to each. Managers across an organization or department use the Control Activities List to select the activities appropriate for each business process. Once selected, a Framework of Internal Controls documents the controls selected for each business process and allows managers to quickly ascertain the controls in place.

Internal Control	Definition	Number	Control Activities
Approvals, Authorizations (Preventive)	Permits execution of transactions within defined parameters	**1-1**	Written policies and procedures
		1-2	Limits to authority
		1-3	Supporting documentation
		1-4	Escalation procedures for unusual items
		1-5	No blank signed forms
Reconciliations (Detective)	Relates different sets of data to one another to identify differences	**2-1**	Reconciliations performed on a timely schedule
		2-2	Differences are resolved and reported
		2-3	Responsibility for performing reconciliations segregated from authorization and custody
Performance Reviews (Detective)	Compares operational results to expected results, historical performance, or benchmarks	**3-1**	Budgeting procedures
		3-2	Budget to actual comparison
		3-3	Current to prior period comparison
		3-4	Performance indicators updated
		3-5	Follow-up on unexpected results or unusual items
		3-6	Senior management review of results
Physical Security (Preventive and Detective)	Restricts access to physical assets and periodically reconciles physical assets to records maintained	**4-1**	Security of physical and intellectual assets
		4-2	Physical safeguards
		4-3	Perpetual records are maintained
		4-4	Periodic counts/physical inventories
		4-5	Compare counts to perpetual records
		4-6	Investigate/correct differences
Segregation of Duties (Preventive)	Separates authorization, recording, and custody of assets among different employees		Different employees:
		5-1	Initiate the transaction
		5-2	Approve the transaction
		5-3	Record the transaction
		5-4	Reconcile balances
		5-5	Handle assets
		5-6	Review reports

Building a Framework of Internal Controls Example

Building a Framework of Internal Controls requires:

- Well defined business objectives, processes, and transactions or decisions points
- Risk rating used to organize the business objectives and processes
- Standard set of control activities such as the control activities listed in the previous table

To develop a Framework of Internal Controls:

1. List business objectives using the associated risk rating to rank them.
2. List the business processes used to achieve each business objective.
3. List the transactions and decision points within each business process.
4. Select and briefly describe the control techniques used within each transaction and decision point.
5. List documentation and forms used in each transaction and decision point and provide a link to documents stored online or in a knowledge management tool.

The Framework for Internal Controls example on the following page shows how a business objective

Framework of Internal Controls Example

Risk Rating	Business Objective	Business Process	Transaction/ Decision Point	Control Activities	Control Activities Description	Documentation / File Location
Med	Certify Funds Availability	Review Funding Requests	Request Received	1-1, 1-3 1-4, 5-1, 5-4 1-1, 1-5	Offices submit request in writing Manager assigns request to analyst Funding documents request on Form	Funding Policy Funding Procedure Form
			Requested Funds Evaluated	1-1, 3-1, 3-2, 5-5	Budget for allocated funds stored on automated system	System User Guide Budget Policy Budget Procedure
			Determine Funding Available	1-5,	Manager certifies funding availability on From	Form
			Form Forwarded for Approval	1-5, 3-6, 5-3	Funding is approved only after funding availability is certified	Funding Policy Budget Policy

Benefits of Using a Framework of Internal Controls

Using a Framework for Internal Controls provides several benefits directly related to improving the control environment and additional benefits that improve other aspects of an organization.

A Framework of Internal Controls benefits the overall control environment by:

- Directly relating internal controls to business objectives and risk assessment ratings
- Providing managers with a standardized list of control activities available with clear definitions applicable to the business environment
- Facilitates a uniform control structure throughout an organization
- Focuses managers on the business objectives and selecting control activities most appropriate
- Provides a structure that knowledge management tools can use to structure related documentation
- Depicts both the business and control structures in an format that is easy to understand, test, and communicate
- Facilitates changes to the control structure as business processes change over time
- Minimizes the time required to plan and document internal controls